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No. 86-416

In the Supreme Court of the United States

OCTOBER TERM, 1986

VIRGINIA Z. HARWOOD, ET VIR AND
MARGARET P. HARWOOD, ET VIR, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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Petitioners contend that their gifts of partnership interests to family members should be valued for federal gift tax purposes at book value.

1. Petitioners Morris and Arthur Harwood, who are brothers, have been partners since 1955 in the Harwood Investment Company, a California partnership that owns and manages timberland (Pet. App. 22-23, 25, 104). At the beginning of 1973, each held a 45% interest in the partnership, and their sister Suzanne held the remaining interest (*id.* at 29). Each brother transferred a 3% interest to Suzanne in 1973 and a 9% interest to a trust for his children in 1976 (*id.* at 105-106).[1] These transactions left

[1] Petitioner Virginia Harwood is a party because she owned a community property share in the partnership interests trans-

each brother with a one-third interest in the partnership (*id.* at 44).

At the times these transfers occurred, the agreement governing the partnership contained a "buy-out provision." That provision stated that if a partner were to die, become incompetent, enter bankruptcy, or "withdraw," thereby causing the partnership to dissolve, any successor partnership could purchase his interest at "book value" (Pet. App. 34-35, 49-50, 112 n.8). Book value for this purpose would not take into account the partnership's goodwill or any unrealized appreciation in the partnership's assets (*id.* at 35).

2. On their federal gift tax returns, petitioners reported the 1976 transfers as gifts and valued them at their book values on the dates on which they were made; petitioners filed no gift tax returns with respect to the transfers made in 1973.[2] On audit, the Commissioner found that both the 1973 and the 1976 transfers were gifts and that the value of each gift for gift tax purposes was the fair market value of the partnership interest on the date of the transfer. Those fair market values were much higher than the corresponding book values, and the Commissioner accordingly determined deficiencies in gift tax. Pet. App. 18-19.

Petitioners sought redetermination of the deficiencies in the Tax Court, contending primarily that the

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ferred by her husband Arthur (Pet. App. 37). Petitioner Margaret Harwood, wife of Morris, is a party because she consented to have the 1976 transfer treated as made one-half by her (*id.* at 53). See Section 2513 of the Internal Revenue Code (26 U.S.C.).

[2] Petitioners contended that the 1973 transfers were for adequate consideration and did not constitute taxable gifts. The courts below rejected that contention (Pet. App. 61-65, 106-111), and petitioners do not pursue it here.

gifts should be taxed at book value. They argued that each gift constituted a partial "withdraw[al]" of the donor-partner's interest within the meaning of the partnership agreement and that the partnership thereby acquired an option, which admittedly was never exercised, to buy the transferred interests from the donees at book value. Accordingly, petitioners argued that the value of the interests could on no account exceed that option price. Pet. App. 67-70. Alternatively, petitioners urged that the interests be valued in accordance with the appraisal of their expert witness, who estimated the worth of the partnership by capitalizing its earnings (*id.* at 76-77). The Commissioner submitted an expert appraisal that reached a higher valuation; that appraisal was based on the value of the partnership's assets, including its timber holdings, as determined by comparable sales (*id.* at 54-55, 79-82).

3. Following a trial, the Tax Court sustained the deficiencies in part (82 T.C. 239; Pet. App. 17-101).[3] The court rejected petitioners' argument that the book value of the gifts dictated their valuation for gift tax purposes. The court explained that the premise behind petitioners' argument—that the gifts constituted "withdrawals" activating the buy-out provision in the partnership agreement—"does not withstand close scrutiny" (82 T.C. at 262; Pet. App. 70). The court found no basis for concluding that the partnership (which consisted of petitioners and their sister) could have forced the donees (who consisted of the sister and petitioners' children) to sell their

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[3] Because portions of the Tax Court's opinion, including all of the footnotes, have been omitted from the appendix to the petition, we are also citing to the appropriate pages of the official report.

interests at book value immediately after the transfers. Rather, the court concluded that the buy-out provision gave any successor partnership the right to purchase the donee's interests at book value only if the donee were to die, become incompetent, be adjudicated a bankrupt, or completely withdraw from the partnership. In the absence of the occurrence of any of those events, the donees were entitled to all the benefits of ownership. The Tax Court acknowledged that the buy-out provision was a factor, among many others, that was relevant to the valuation inquiry, but it concluded that that provision was not the exclusive determinant of the value of the transferred interests. 82 T.C. at 260-269; Pet. App. 65-89.

With respect to the conflicting appraisals, the Tax Court found that the one prepared by the Commissioner's expert provided a more reliable basis for determining the fair market value of the partnership on the relevant dates (82 T.C. at 264-269; Pet. App. 74-89). While noting that "[t]he demonstrated earning capacity of the business' " enters into that determination (82 T.C. at 264; Pet. App. 75, quoting Treas. Reg. § 25.2512-3(a)(2)), the court ruled that the capitalization-of-income approach used by petitioners' appraiser was unsatisfactory. The court explained that petitioners' appraiser had taken too little account of the cyclical nature of the partnership's earnings and had failed to furnish adequate support for the capitalization rate he chose. The court also suggested that, given the nature of the partnership's business, a potential purchaser would attach more importance to the asset value of the partnership's timber holdings, as did the Commissioner's appraiser, than to the partnership's past profits. 82 T.C. at 265; Pet. App. 76-79.

The court of appeals unanimously affirmed in an unpublished opinion (Pet. App. 102-121). The court held that the price stated in the buy-out provision did not fix the value of the transfers for gift tax purposes. The court of appeals agreed with the Tax Court that petitioners failed to show that the gifts of minority interests in the partnership constituted "withdraw[als]" within the meaning of the partnership agreement (*id.* at 111-113). On the question of which appraisal to follow, the court of appeals found that the Tax Court's determinations of value were based on competent evidence and were not clearly erroneous (*id.* at 118-121).

4. The decisions below are correct. Petitioners do not allege a conflict among the circuits on the question presented; indeed, they concede (Pet. 8-9) that the courts below followed the uniform judicial approach to this question of gift tax valuation. Petitioners' arguments are essentially factual and warrant no further review.

Petitioners' contention (Pet. 6-12) that the book value of the partnership interests is binding for gift tax purposes was correctly rejected by both courts below. In general, the value of property for gift or estate tax purposes is its fair market value. That value is defined as the price that a willing purchaser would pay to a willing seller, with neither being under any compulsion to buy or sell and both having reasonable knowledge of the pertinent facts. Treas. Reg. §§ 20.2031-3, 25.2512-1. Owners of business interests sometimes execute "buy-out" agreements that restrict their rights with respect to the disposition of such property, and these agreements can affect the fair market value of the property for tax purposes. But, under the circumstances presented here, it is clear that the buy-out provision in petitioners' part-

nership agreement did not have the effect of establishing book value as the gift tax valuation of the transferred shares.

Petitioners correctly state (Pet. 7-9) that the courts have traditionally accorded different weight to buy-out agreements depending on whether the property is sought to be valued for gift tax or estate tax purposes. The reason for this differential treatment is most easily demonstrated by an example, which illustrates the relevant principles and shows why petitioners err in their assumption (see Pet. 6-9) that there should be no difference between the two valuations.

Assume that the shareholders of a closely-held corporation enter into an agreement that grants the corporation an option, upon a shareholder's death, to purchase the deceased shareholder's stock at a specified price. This price obviously places an upper limit on the value at which the stock is included in the decedent's gross estate for federal *estate* tax purposes, even though in the absence of the agreement a higher value might apply. This is because the critical event that triggers the option—the death of the shareholder—has occurred, thereby making the stock immediately available for purchase at the price stated in the agreement. If the stock in the hands of the estate is theoretically worth more than the option price, the corporation can be expected to exercise the option, with the result that no willing buyer would pay more for the stock than the price represented by the option price. See, *e.g.*, *Brodrick* v. *Gore*, 224 F.2d 892, 896 (10th Cir. 1955); *May* v. *McGowan*, 194 F.2d 396, 397 (2d Cir. 1952).

By contrast, the agreement described in our example would not have the same limiting effect on

value for *gift* tax purposes. A shareholder who made a gift of his stock would not trigger the option provision. The donee would thus receive the full rights of ownership of the stock, including the right to dispose of it at its current value by any method other than testamentary disposition. The restriction represented by the buy-out provision accordingly would not preclude the shares from having a gift tax value in the hands of the donee higher than the option price, although the value might be depressed somewhat by the possibility that the option would mature in the future upon the donee's death. The buy-out clause would thus be a factor—but only one factor—in appraising the stock for gift tax purposes. See, *e.g.*, *Spitzer* v. *Commissioner*, 153 F.2d 967, 970-972 (8th Cir. 1946); *Estate of Reynolds* v. *Commissioner*, 55 T.C. 172, 187-190 (1970).

Petitioners recognize the applicability of these principles. They note the distinction between a restriction "which is triggered by a transfer" and a restriction that "will not become effective until some future time" (Pet. 11). And they acknowledge that a buy-out provision does not fix the value of property for tax purposes in the latter case because "the donee can be expected to have an indeterminate period of unconditional use" before the contract restriction comes into play (*id.* at 12). Necessarily, therefore, petitioners' contention is that the buy-out provision in their partnership agreement falls into the former category, *i.e.*, that the donative transfers involved here amounted to "withdraw[als]" from the partnership that triggered the partnership's right to buy the donees' interests immediately at book value.

Both courts below correctly rejected this essentially factual contention (see 82 T.C. at 262; Pet. App. 70-

71, 111-113). The operative provision of petitioners' partnership agreement states that, if any partner shall "withdraw" from the partnership, any "successor" partnership may purchase the withdrawing partner's interest at book value (Pet. App. 50). But the transfers in question did not cause any partner to "withdraw." Following the transfers, Morris and Arthur each remained a partner, although his partnership interest was reduced by stages from 45% to 33% (*id.* at 44). Nor did these transfers cause the existing partnership to dissolve and a "successor" to be formed. The Uniform Partnership Act makes clear that "[a] conveyance by a partner of his interest in the partnership does not of itself dissolve the partnership" (Cal. Corp. Code § 15027(1) (West 1977)). What the restrictive clause here contemplates is the buy-out of the full interest of a withdrawing partner, not the buy-out of a partial interest received by a continuing partner's transferee. In short, the buy-out option was not triggered by the gifts involved here, and hence there is no basis for valuing the transferred partnership interests at book value for gift tax purposes.

5. Petitioners also assert (Pet. 12-14) that the Tax Court's refusal to adopt the findings of their appraiser, who examined the earnings history of the partnership, ignored fundamental principles of valuation. But the court plainly recognized that " '[t]he demonstrated earning capacity of the business' " ordinarily plays a major role in determining the fair market value of a business. 82 T.C. at 264; Pet. App. 75 (quoting Treas. Reg. § 25.2512-3(a)(2)). The court discounted the appraisal of petitioners' expert, not because he applied the capitalization-of-earnings method, but because of the manner in which he did

so. In the Tax Court's view, the appraiser did not adequately allow for fluctuations in the partnership's earnings, and he failed to justify his selection of a capitalization rate. 82 T.C. at 265; Pet. App. 77-78. The court found that the appraisal submitted by the Commissioner's expert was free of such shortcomings. The court of appeals examined the record and sustained the Tax Court's findings of fact (Pet. App. 118-121). There is no reason for this Court to review these concurrent findings of the courts below.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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